

Views on Proposed “Predatory Lending” Legislation

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I. Introduction

We appreciate the opportunity to address the issue of “predatory lending” and the proposed legislation. We’d like to begin by providing some background on our company.

Quicken Loans is a Michigan-based retail residential mortgage lender. We have been in business since 1985, and have over 3700 employees, over 3300 of them in southeast Michigan. We do business in all 50 states. We are one of the nation’s 20 largest retail mortgage lenders, the largest online lender, and Michigan’s largest mortgage company. We typically close about 7,000 to 10,000 loans each month, or about \$1.2 billion to \$1.6 billion in total loan volume per month. In 2007, we were voted “The Best and Brightest Company to Work for in Metropolitan Detroit” by the Michigan Business and Professional Association for the second time. We have also been ranked in the top 20 on Fortune Magazine’s list of the “100 Best Companies to Work” in the country for the last four years.

Until recently, (i) about 10% of our loan production was of the type commonly considered “sub-prime” and (ii) about 30% of our loan production fit the category of “non-traditional,” which term generally encompasses interest only loans, payment option loans and other less traditional loans.

II. The Current Environment and the “Predatory Lending” Discussion

The term “predatory lending” is used loosely by different people and organizations to cover the entire gamut of lending activities, and there is no clear consensus on when exactly these practices cross over from the realm of legitimacy to that of predation. The term should be used only when discussing inherently abusive practices, involving fraud and deception. Fair, legitimate and legal lending practices should not be considered “predatory.” For instance, mere “sub-prime” lending should not be considered “predatory”, for sub-prime lending is simply a matter of charging higher rates/costs that appropriately reflect the risk of lending to certain borrowers. There is nothing unfair, abusive or illegitimate about this practice.

The current discussion about predatory lending is not new. For several years, interested parties in all 50 states and in the federal government have been introducing and debating various bills and in some instances, enacting legislation. For the most part, the debate has been restrained and deliberative—resulting mostly in reasonable legislation or the realization that legislation would be unproductive or counter-productive.

The credit crunch of this past summer has dramatically altered the environment. Loan programs and underwriting standards of the recent past have proven to be too lax and a large number of homes loans are in default and/or foreclosure. Understandably, legislators and others want to help the individuals in question and to prevent these types of problems in the future. They want to act quickly and emphatically.

As we will discuss, the heightened desire to fix this complicated problem in the midst of a “crisis” style atmosphere carries significant risk—namely the risk that policy makers will misjudge the nature of the problem and institute a “solution” that will make the problem worse. The mortgage market has already corrected itself through tightened underwriting standards and a devaluation of riskier loans. New legislation is simply unnecessary and potentially harmful. We urge the Committee and others to show restraint and consider the entire context of the current situation before taking legislative action.

III. Challenging the Assumptions

There are three key assumptions in the predatory lending discussion that are, in fact, worthy of deeper scrutiny: (A) that the majority of borrowers who receive sub-prime or non-traditional loans do not understand the type of loan they have chosen and do not understand the risks which accompany these loans (B) few consumers actually benefit from sub-prime and non-traditional loans, and such loans exist primarily as a vehicle by which unscrupulous lenders can profit from unsuspecting borrowers and (C) there is a paucity of lender regulation or market forces to keep lenders in check.

Let’s examine each of these assumptions.

A. Understanding the Loan and the Risk

There are certainly some consumers who lack knowledge and experience in financial matters and unscrupulous lenders and loan officers who will purposely take advantage of them. But for the most part, people have the capacity to understand basic financial concepts and should retain the fundamental freedom to be able to make decisions themselves, rather than have their options limited by legislation. Loan provisions such as adjustable rate mortgages with low start rates, interest only loans and prepayment penalties are not as daunting and complicated as some would make it seem, particularly when accompanied by required disclosures (admittedly, these government mandated disclosures are sorely lacking in clarity—an issue that we will address later). In fact, in most instances borrowers request and even demand the very things that lenders are being accused of forcing upon them—things such as low monthly payments at the beginning of the loan term, the ability to pay taxes and insurance separately and the ability to use “stated income” to qualify for the loan. It is impossible to determine exactly which borrowers are and are not victims of deception. But the prevailing sentiment that most sub-prime and non-agency borrowers are victims of predation seems rather over-stated.

A consumer who applies for a loan, receives all of the required disclosures and is not defrauded by the lender, and then later expresses dissatisfaction or regret with the terms of his/her loan should not be considered a victim of predatory lending. We must avoid attaching the “predatory lending” label to every instance of customer regret or dissatisfaction.

B. The Benefits of sub-prime, non-traditional and adjustable rate loans

While sub-prime, non-traditional and adjustable rate loans are not the best fit for everyone and some consumers may on occasion be improperly steered toward these loans, we must remember that for the most part, these loans *benefit* the consumers who receive them.

Sub-prime Loans

It is often cited that 20% of sub-prime borrowers in Michigan are in delinquency. We note the following:

- Statistics regarding sub-prime loans are inherently flawed because there is not a clear uniform definition of the term “sub-prime.” Thus, statistics vary depending on how that term is defined.
- Assuming for the sake of this discussion that the 20% figure is accurate, there is no evidence that the 20% figure, while high by historic standards and by comparison to the rest of the country, is disproportionate when considering the unemployment and other economic ills affecting our state.
- 80% of sub-prime borrowers are *not* delinquent, and are enjoying the benefits of the loans that they chose.

As to the last point, the Mortgage Banker’s Association reports that about 45% of sub-prime borrowers use the loans to buy homes, with 25% of the purchases by first-time homebuyers. Most of the remaining 55% use the loans to pay off expensive credit card debt—often in the 15% to 20% range—thereby saving themselves money, and to take cash out to be used for home improvements, education, health care and other expenses. While a sub-prime loan is not ideal for any consumer, it is a much better alternative than living in an apartment, renting a home, being saddled with high-interest credit card debt or being unable to use one’s own home equity to improve one’s life.

A real-life example would be helpful here. In mid-August 2006, Mr. X, a resident of Byron Center, Michigan came to us looking to take equity out of his home to pay off about \$15,000 of high interest credit card debt. His credit score was in the mid 500’s, and while this disqualified him from receiving a “prime” loan, he was approved for a 40 year fixed rate “sub-prime” loan at 8.65%, a much lower rate than he was paying on his credit card debt. He closed in mid-September of 2006. By consolidating his debt (including paying off “collection accounts”), he reduced his monthly payment by \$452—based on his minimum monthly credit card payments. His total costs were \$7,930, which means that by 18 months from his closing, he will be past the “break-even point.” Mr. X is very satisfied with his loan and gave his lender the highest possible rating on the customer feedback form he completed at closing.

Non-Traditional Loans

Over the years, the mortgage industry has adapted to meet the needs of consumers who want more affordable options and policy-makers who have urged increased home ownership and relaxed standards to meet the needs of low-income and underserved consumers. This innovation has resulted in interest only loans, payment option loans and other “non-traditional” loans that make good financial sense for certain people in certain situations. Our nation’s record nearly 70% home ownership and record home ownership levels for racial and ethnic minorities can be attributed, in part, to this innovation and flexibility.

These loans are not “trick loans” or “gimmicks.” Rather, they are slightly more complicated loans geared toward consumers with good credit and who desire flexibility due to uneven income streams or other personal circumstances. These loans have benefited a great many people and the delinquency rates have been very low.

Another real-life example would be helpful. Ms. Z had recently been divorced and was looking to start a new life in a new home. She found a home for \$183,000 in Southfield, Michigan. She could not be approved for a “traditional” mortgage. So she applied for a “non-traditional” loan, which required payments of interest only, at a secured rate for 10 years. After 10 years, her monthly payment will increase by \$300 for the remainder of the loan term. So, Ms. Z has 10 years to prepare for and plan for this payment increase. At closing, on her “client survey” form, Ms. Z wrote “Fred (her loan officer) and Derek (her loan processor) were outstanding. I could not have made my dream a reality without them. Thank you Fred and Derek.” So, far Ms. Z has been able to pay a little extra money toward the principal loan balance in her monthly payments.

In the last two years, the underwriting parameters for sub-prime loans became rather loose and delinquencies have risen accordingly. This caused the secondary mortgage market for sub-prime loans to essentially dry up. In other words, the market self-corrected. Unfortunately, at about the same time, the secondary market overreacted and stopped purchasing non-traditional loans, even though the delinquency rates were low. Both sub-prime loans and non-traditional loans are likely to become available again once the market correction is complete. It is crucial that we avoid enacting well-intended but over-reaching legislation that would prevent the re-emergence of these important home loan options.

Adjustable Rate Mortgages

Much has been said and written about the shortcomings of adjustable rate mortgages (“ARMs”), in particular the practice of underwriting these mortgages at the “start rate” instead of the fully indexed rate.

For many years, ARMs have allowed consumers the choice to trade off the benefits of a lower monthly payment for an initial period with the risks of increased payments later. All ARM loan packages include full written disclosures (at application and again at

closing) detailing the initial start rate, the method and timing of future rate changes and the lifetime cap on the rate. As with sub-prime loans and non-agency loans, ARMs make sense for certain consumers in certain situations—such as (i) a professional nearing completion of her schooling or internship wishing to purchase a home and knowing that her income is likely to increase in the future or (ii) a person who knows they will be selling their home within a few years, and wants a loan with the lowest rate possible during that time. Most hybrid ARMs (i.e. ARMs with an initial fixed rate period of two to 10 years) are refinanced before the consumer even makes an adjusted payment.

Many are now calling for a prohibition against the long-standing, standard practice of underwriting ARMs based on the initial interest rate, rather than the fully indexed rate. Such a prohibition does not make sense when you consider that most ARMs *never even reach* the fully indexed rate. In fact, most hybrid ARMs (i.e. ARMs with an initial fixed rate period of two to 10 years) are refinanced before the consumer even makes an adjusted payment. While such conservative underwriting might theoretically prevent some borrowers from being approved for a loan that might not be best for them, the prevailing effect would be that many consumers who desire and could handle such loans would regrettably be denied access to those loans. They will be forced to either forego a loan altogether, or to accept a loan that results in a higher monthly payment. Such an overreaching prohibition and denial of a borrower's and lender's basic freedom to contract would be classic example of "throwing the baby out with the bathwater."

C. Lender's are already heavily regulated

Proponents of increased mortgage lending regulation tend to overlook the fact that mortgage lenders are *already* heavily regulated. For example, existing federal laws which regulate lender practices include the Truth-In Lending Act, the Home Ownership and Equity Protection Act (specifically "Section 32"), the Fair Credit Reporting Act, the Real Estate Settlement Procedures Act and the Equal Credit Opportunity Act. Just five years ago, the state of Michigan enacted the Consumer Mortgage Protection Act, which mandated additional disclosures and a "Borrower's Bill of Rights." The Office of Insurance and Financial Services and to some degree, the Attorney General's office each provides oversight and enforcement.

Outside of the regulatory environment, lenders are scrutinized by many consumer watchdog and advocacy groups, the Better Business Bureau, plaintiff's attorneys, small claim's courts and consumer based websites. In addition, the discipline of the marketplace regulates lender practices while also affording consumers many options when it comes to home financing. And soon, the state of Michigan is likely to enact loan officer licensing legislation, which will require, among other things, criminal background checks and training for all Michigan loan officers.

Such regulation has clearly resulted in higher compliance costs, which have in turn, resulted in increased costs/rates and paperwork to borrowers. Much less clear is whether this regulation has had the intended effect of helping the consumers it was intended to serve. We must consider whether additional legislation at this time would succeed where

past efforts have not, and whether the cost of such legislation is truly worth the perceived benefit.

Another rarely discussed “check” on lenders is the very nature of the foreclosure process and the secondary mortgage market. Foreclosures are costly and cumbersome, such that lenders have every reason to avoid them. As we have already seen this past summer, if lenders’ underwriting guidelines become too loose and delinquencies and foreclosures become too prevalent, lenders will adjust their underwriting standards accordingly. Legislating underwriting standards is simply not necessary.

In addition, although many lament that often the entity originating the loan is not the same as the entity underwriting or servicing the loan, it is inaccurate to say that the originating entity bears no consequences for delinquencies. Most secondary market loan purchasers have formal agreements with their correspondent loan originators which require the originators to repurchase delinquent loans in many instances. Further, these secondary market lenders track the loan performance of each of their correspondent originators and hold them responsible for loan performance, often terminating their relationship if their loan performance is sub-standard. Thus, originating lenders do indeed have the incentive to make sure that the loans that they originate do perform.

IV. The Secondary Mortgage Market

The relationship between the entity originating the loan and the loan purchasers on the secondary mortgage market requires further discussion, for there seems to be much misunderstanding—particularly with respect to the effects of securitization and the possible effects of “assignee liability.”

Securitization

The process of “securitization” occurs when large financial institutions purchase and bundle disparate loans originated by various entities from all over the country. These institutions subsequently sell these bundles to Fannie Mae, Freddie Mac and investment banks, who in turn sell the packages as securities to investors.

Securitization undoubtedly alters the traditional, simple relationship between lender and borrower and limits the risk inherent in any one loan. But securitization and the spreading of risk has provided an abundance of capital to the mortgage markets, making mortgage loans more accessible and more affordable for consumers all over the country. This has enabled millions of consumers to enjoy the benefits of home ownership and lower mortgage payments, and has bolstered our economy.

Assignee Liability

Securitization can provide the benefits described above *if and only if* the investors purchasing the securities can understand and quantify their risk. Investors value certainty and they will not put their capital at risk in states where they may be held liable for the

originating entity's failure to comply with the law, particularly when that law is vague and subjective. Such "assignee liability" provisions have the unintended consequence of driving up interest rates to compensate for the extra risk, or drying up capital altogether. This leads to ruinous implications for the housing market and for those who have historically been frozen out of the mortgage market, such as lower income consumers and ethnic minorities. We urge extreme caution and prudence when considering assignee liability provisions.

The events that transpired in the state of Georgia illustrate this point. In October 2002, Georgia enacted a law which contained many subjective provisions (e.g. a "tangible net benefit test") and strict assignee liability provisions which covered loans beyond the federal definition of "high cost" loans. The legislation was widely considered to be overreaching. Soon, Standard & Poor's announced it would no longer assign credit ratings to many mortgage securities containing Georgia loans because the potential legal risk could taint the securities. Numerous secondary market investors ceased purchasing mortgage loans backed by Georgia residential property, thus drying up the capital available to Georgia citizens. The Georgia legislature realized the disastrous effect of its legislation, and in March 2003, wisely amended the legislation to conform the definition of "high cost" loans to the national standard, to clarify ambiguities and to limit assignee liability. Secondary market investors returned to Georgia and accordingly, mortgage loans were again made readily available to Georgia citizens.

Some may argue that predatory lending legislation enacted in other states (e.g. North Carolina) has *not* caused legitimate lenders to stop doing business in that state. Although to some extent, that may be true, the type of legislative proposals we are seeing now are *far* more overreaching than what was enacted in the past—especially with respect to assignee liability and subjective underwriting criteria. In addition, the overall mortgage lending environment has changed dramatically due to the events of this past summer such that the capital markets are now extremely wary of mortgage lending. Overreaching predatory lending legislation enacted in this environment will undoubtedly have a much greater negative effect on liquidity and capital availability than any legislation that was enacted over the past several years.

V. Proposed Legislative Provisions

Legislators and policymakers have proposed various legislative methods to combat "predatory lending." Below are some comments on some of the methods.

Prohibition Against Prepayment Penalties- Pre-payment penalty clauses provide that if the borrower pays off the loan within a set period of time, the borrower must pay a fee. On the surface, such a provision seems like a harsh deterrent for borrowers wishing to pay off their loan and replace it with a loan with better terms. But in reality, prepayment penalties constitute a valid, market driven method by which lenders in the secondary mortgage market can even out their earnings streams and hedge against interest rate shifts. Such provisions help to drive the cost of lending down, which consequently, leads to better loan pricing for the consumer. Assuming the prepayment penalty is properly

disclosed to the consumer, the consumer is afforded the opportunity to assess the tradeoffs between a loan with and without a prepayment penalty. Borrowers are not forced to close on loans with pre-payment penalties and the existence of any type of properly disclosed pre-payment penalty should not be prohibited or otherwise deemed “predatory.”

“Reasonable Tangible Net Benefit” Provisions- Some policymakers have considered provisions which prohibit lenders from refinancing a loan unless the lender can show that there is a “reasonable tangible net benefit” to the borrower. At first blush, this burden may seem easy to meet—a mere matter of comparing the new interest rate to the old interest rate.

But upon closer examination, the following questions arise:

- (i) What if the borrower is paying off an adjustable rate loan and opting for a fixed rate loan at a higher rate (and higher monthly payment) because she believes interest rates will increase in the future? Is the security of the fixed rate a “tangible net benefit” as weighed against the certainty of immediate higher payments?
- (ii) What if the borrower is paying off a fixed rate loan and opting for a “riskier” interest only loan because she anticipates that the coming years will be tough for her economically and she may need payment flexibility? Does this tradeoff provide a “tangible net benefit?”
- (iii) What if the borrower pays off a fixed low interest rate loan and substitutes a higher interest loan, but gets “cash out” to pay for home improvements? Does it matter if the home improvements are to the kitchen vs. the recreation room? Does it matter whether the cash is put toward his child’s college education? To take a family vacation? To pay a debt owed to his bookie? Exactly how is the lender supposed to determine whether the borrower is experiencing a “tangible net benefit” from the choice that the borrower is making?

To hold the lender responsible for the “reasonableness” of the borrower’s choices--of the borrower’s assessment of the benefits and costs of the various options available to him--is patently unfair and is the type of subjective provision that will lead to numerous frivolous lawsuits and drive lenders and secondary market investors away from doing business in Michigan.

Underwriting requirements- Rigid underwriting standards should not be written into legislation, for the mortgage markets must be able to adapt quickly to market innovations, as well as changes in consumer preferences, statistical analysis and technology, all of which will affect how loans should be underwritten. Government imposition of permanent, “hard-coded” underwriting rules upon the marketplace is neither feasible nor advisable.

Further, the institution of subjective standards such as a requirement that a lender have a “reasonable belief” that the borrower will be able to make their payments are wholly

unnecessary and impractical. Loan underwriting can be complicated and difficult, and reasonable underwriters can and do differ on how to calculate debt and income, how to properly establish a property's value and how much weight to give the various factors which go into a decision to lend. Statutorily imposing the murky standard of "reasonableness," under threat of a government or private right of action for failure to meet such standard leads to the very real possibility that underwriters would soon be responsible for:

- (i) ascertaining the financial stability of the borrower's employer (e.g. Should a Ford employee be underwritten differently than a Toyota employee? And what if an employer doesn't publicly release its financial statements?)
- (ii) reviewing the borrower's employee reviews to ascertain the likelihood of continued employment
- (iii) analyzing the borrower's health or the quality of the borrower's marriage to ascertain whether future events might affect the likelihood of re-payment
- (iv) determining how much money a new homebuyer is likely to spend on furniture, carpeting, and appliances after the loan closes
- (v) analyzing anything and everything which might affect the borrowers ability to repay the loan.

The possibilities for lawsuits are limitless. The legislature should not statutorily substitute its judgment for that of the loan underwriter in trying to determine whether borrowers have the ability to re-pay the loan, particularly when standards set forth are vague and subjective. Such subjective, overreaching provisions will drive loan originators and secondary market investors from the market, cause those that remain to become ultra-conservative in their underwriting decisions and set in motion an unprecedented amount of litigation. This will in turn significantly reduce the affordability and availability of mortgage loan options for the very consumers such legislation is intended to serve.

Disclosures-Policy makers often look toward additional disclosures as the antidote to potential "predatory lending." Simply adding to the long list of poorly worded disclosures that borrowers already are required to sign would, for the most part, be unhelpful, and would simply make the mortgage process even more difficult and expensive. As a matter of fact, most borrowers don't even read these disclosures; and the few who actually do read them, still choose to proceed with the transaction.

On the other hand, *clear, easy-to-read* disclosures make great sense, for such disclosures would ensure that borrowers truly understand the risks inherent in their loan—or at the very least that they are afforded a legitimate opportunity to obtain such understanding. The current disclosures that borrowers receive—such as the Truth-in-Lending statement and the Good Faith Estimate—are sorely lacking in clarity and relevance, and many of the ARM disclosures are too lengthy and complicated. Generally speaking, lenders would support of a major overhaul of the disclosures that borrowers receive.

VI. Possible Solutions

Beyond the significant improvement of disclosures, there are some other things that can be done to assist borrowers:

Better Enforcement of Existing Laws- We must do a better job of cracking down on cases of lender fraud, for if lenders are indeed committing fraud, they should be put out of business. There is no need for additional legislation -- fraud is *already* illegal and there are numerous statutes and court rulings clearly defining what constitutes fraud.

The idea of enforcing anti-fraud legislation seems pretty basic and fundamental. Yet, it seems that the government agencies responsible for enforcement of the anti-fraud provisions are under-staffed and under-funded. Before creating any new, far-reaching legislative initiatives which also will need to be enforced, policy makers should focus on the enforcement of existing laws.

Education- Borrower education is a key, for the mortgage lending process can be somewhat complicated. An educated borrowing public is the best antidote to the predatory lending problem.

The effort here should not be limited to educating *adult* homeowners about the mortgage lending business and how to choose the right loan, for by the time most borrowers reach the stage where they are evaluating sub-prime loan options, it is probably already too late. Their credit is probably already blemished and they don't have many good options from which to choose. The primary goal of any educational efforts should be to help people avoid the situations that cause them to seek out sub-prime loans. People need to be educated about the risks of developing bad credit and how the effects will leave them vulnerable to predatory lending practices in the future.

Community education should target *teens and young adults* long before they consider buying their first house. High schools and community colleges should offer courses in the real-life skills of personal financial management. The state should mandate financial education as part of the standard high school curriculum.

Loan Officer Licensing- Individual loan officers play an extremely important role in any residential mortgage loan transaction. The loan officer counsels the borrower with respect to interest rates and loan programs and helps the borrower choose the loan that best meets their needs. The performance of the loan officer is one of the main factors affecting the degree of borrower satisfaction.

Realizing the importance of the loan officer's role, more and more states are requiring that loan officers be individually licensed. Licensing typically requires that prospective loan officers undergo a criminal background check, receive varying amounts and types of training and pass a proficiency exam. Further, the existence of the licensing system allows states to track the movements of dishonest loan officers.

Of course, the mere attainment of a license does not make an incompetent person qualified or render a dishonest person honest. And poorly designed loan officer licensing

requirements with inordinately high licensing fees and poorly considered provisions would do more harm than good. But properly constructed loan officer licensing legislation and enforcement of the licensing provisions will go a long way toward preventing some of the problems we have seen.

More important than any of these proposed solutions is the realization that the mortgage market *has already* corrected itself. Hundreds (if not thousands) of mortgage brokers and lenders have went out of business. Most secondary mortgage market investors have stopped purchasing mortgage loans, including prominent companies such as Indy Mac, Morgan Stanley, Bear Stearns, Merrill-Lynch and UBS. Those that are still in the market have tightened their underwriting standards considerably, and have dramatically reduced the compensation they will pay for the sub-prime and non-traditional loans that remain. Basically, Fannie Mae and Freddie Mac are the only significant secondary mortgage market investors remaining. Accordingly, they have raised their costs, as have the PMI companies. This has all caused the availability of credit to dry up and the costs of what credit there is to increase.

The pendulum has already swung to the opposite extreme, which has further exacerbated the current mortgage credit crunch. The market has already dealt with the concerns that policymakers are now seeking to address. Adding more stress to the mortgage lending system at this point via over reaching legislation would be counter-productive.

VII. Conclusion

Ever since the inception of the “predatory lending” debate, the focus has been on the lending community. Nationwide, many government and community leaders have adopted a pattern of blaming lenders for borrowers’ failure to re-pay their loans, pitting the public against the mortgage lending community and labeling the issue as a “crisis.” Rarely is the public reminded that for years and years, policymakers and consumer advocates have pushed lenders to make riskier loans, requiring lower down payments and accepting sub par credit ratings, so as to increase home ownership. While the loan delinquency and foreclosure situation is indeed serious, only anecdotal evidence exists that this is caused by what can honestly be referred to as “*predatory lending*,” or that a significant number of lenders are doing bad things. For the most part, lenders have been making the loans that borrowers knowingly want and choose.

Policy makers should therefore resist the temptation to institute sweeping legislation or regulation. Policy should never be created in a “crisis” atmosphere, for such policy often makes matters worse. In this particular case, overly broad attacks on so-called “predatory lenders” will likely scare away legitimate, law-abiding mortgage lenders which are unquestionably needed in underserved communities. We must take note of how the mortgage market has already corrected itself. Further penalizing the mortgage industry at a time when it is already being punished in the marketplace would serve no effective purpose.

Thank you for taking the time to read and consider our comments. We would be happy to discuss this issue in further detail with any committee members at their convenience.

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